Presents

Research and Development Tax Credits

By
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Agenda

• Introduction
• Technical Overview
• Defining “R&D” – In the Eyes of the IRS
• IRC Section 41 – Credit Requirements
• Qualified Research Expenditures
• What Activities Qualify as Research and Development
• Excluded Activities
• Internal Use Software
• Conclusion
Introduction

• 4 Partners – former “Big 4” experience
• More than 50 years combined tax and consulting experience
• Locations in Cleveland, Chicago, New York, Atlanta, Phoenix and Los Angeles
Michael A. Krajcer - Partner

- Firm’s Technical Director

- More than 20 years of professional services experience including 13 years with the Internal Revenue Service and 5 years with Ernst & Young

- Current clients include companies in the oil & gas, manufacturing, computer software, and financial institution industries

- Attorney and CPA, and Adjunct Professor at the Cleveland-Marshall College of Law
Technical Overview

History of the R&D Credit
Technical Overview

History of the R&D Credit

• Established in 1981 by the Economic Recovery Tax Act of 1981 as a temporary credit (extended 12 times)

• Intended as an incentive for increasing research and development

• Provided for a 20 percent credit for qualifying expenditures over a base amount

• Included a “discovery” requirement and contemporaneous recordkeeping
Technical Overview

Changes that have Broadened the Scope

• Final regulations issued in 2003 removed the “discovery” requirement and relaxed the documentation requirements

• Today, many companies now meet the definition of “research and development” simply by trying to stay competitive

• Any process of experimentation is acceptable

• Extended through December 31, 2007

• Extension of the credit includes a “alternative simplified method”
Definition of Research & Development

In the eyes of the Internal Revenue Service:

R&D begins at concept inception and ends at commercial production
**IRC Section 41 – Credit Requirements**

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IRC Section 41 – Credit Requirements

Business Component Test: The Development or improvement of a:

- Product
- Formula
- Process
- Software
- Invention
- Technique
IRC Section 41 – Credit Requirements

Business Component Test

An improvement needs to be a functional change rather than an aesthetic change

- Functionality
- Reliability
- Quality
- Cost Reduction
IRC Section 41 – Credit Requirements
Technical Uncertainty

- Research activities must be intended to eliminate uncertainty about the capability or method of developing or improving the business component or about its appropriate design
IRC Section 41 – Credit Requirements

Process of Experimentation

- A process designed to evaluate one or more alternatives where the capability or method of achieving a result, or its appropriate design, is uncertain and not readily determinable and applicable at the beginning of the research activities
IRC Section 41 – Credit Requirements

Use of Scientific Principles

• Process of experimentation must rely fundamentally on the principles of the physical or biological sciences, engineering, or computer science

• A taxpayer may use existing principles of these sciences to satisfy the requirements

• “Soft” sciences such as humanities, management sciences, social sciences do not meet these requirements.
Qualified Research Expenditures

Supplies  
WAGES  
Contract Research

Qualified Research Expenditures

65%
## What Qualifies as R&D?

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<th>What Qualifies as R&amp;D?</th>
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<td>• Designing new or improved equipment and components to be used in exploration,</td>
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<td>drilling, and production processes</td>
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<tr>
<td>• Developing innovative technologies and processes for exploration, drilling,</td>
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<td>• Developing new or improved marshaling service processes</td>
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<td>• Developing more efficient and cost-effective subsea interventions</td>
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<td>• Designing equipment and processes to deal with challenging environments</td>
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<td>• Developing of electronic monitoring and control systems and techniques</td>
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<td>• Developing computer software. This applies to software developed internally,</td>
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<td>as well as to vendor created software that is meant for sale or lease</td>
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<tr>
<td>• Developing new or improved injection techniques</td>
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<td>• Designing new processes to deal with environmental issues</td>
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Excluded Activities

- Research conducted after the beginning of commercial production
- Adaptation of an existing business component to a particular customers needs
- Reverse engineering
Internal Use Software

- Special Rules exist for software created strictly for internal use (high threshold of innovation test)
  - Software must be innovative
  - Development includes significant economic risk
  - Software is not commercially available
Conclusion

• Questions?